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Good morning Chairwoman Miller and Congressman Lynch. My name is Damon Silvers and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. The AFL-CIO appreciates the opportunity to testify on the vital issue of the internal controls provisions of the Sarbanes Oxley Act of 2002 have had on our capital markets and in particular the question of whether smaller public companies should have to comply with the internal controls provisions of the Act.

Union members participate in benefit plans with over $5 trillion in assets. Union-sponsored pension plans hold approximately $400 billion in assets. Workers' pension funds are broadly invested in a variety of small-cap and total market index funds and are sizable shareholders in many small public companies.[1] Most importantly for this issue union members participate in the capital markets as individual shareholders and like other

[1] Attached to my testimony is a letter to the SEC from one large pension fund, the Florida State Board of Administration which in the context of explaining why they believe all public companies should comply with Section 404 details the extent and manner in which they invest through indexes in small company equity.

investors are frequently asked by brokers to consider investing in small or micro cap companies.

Since 1977, public companies have been required to have adequate internal controls—however, until the passage of the Sarbanes-Oxley Act there was no specific mechanism for holding public companies accountable to the law. Section 404 of the Sarbanes-Oxley Act requires the management of all publicly traded companies to assess the strength of their companies' internal controls, and then requires that each public company's external auditor attest to the accuracy of that assessment.

Section 404 is a vital component of the integrated series of measures contained within the Sarbanes-Oxley Act designed to regulate conflicts of interest in the governance and financial management of public corporations. It is one of four measures within the Senate version of the Sarbanes-Oxley Act that were incorporated into the Act in conference specifically directed at the widespread problems with the integrity of public company financial statements. The other three measures are the limitations on non-audit consulting by audit firms, the establishment of the Public Company Accounting Oversight Board to oversee the auditors of public companies, and the requirements that the officers of public companies certify the accuracy of their companies' financial statements.

It is impossible to overestimate the importance of the integrity of public company financial statements to the functioning of our capital markets. When investors lose

confidence in financial statement integrity, stock and bond prices fall, interest rates rise, and investors seek out markets in which they have more confidence. With a current account deficit running at a rate in excess of $2 billion per day, the United States simply cannot afford to undermine the integrity of its capital markets in whole or in part.

The enactment of the Sarbanes-Oxley Act in the summer of 2002, together with the successful launch of the PCAOB was critical to restoring the confidence of investors both here and abroad in the integrity of US financial statements. Now, almost four years later, there are those who would weaken investor protections. Perhaps the best known statement of this point of view appears in the recommendations of the Small Business Advisory Committee ("Committee") established by the Securities and Exchange Commission ("SEC"), which has proposed that small public companies be exempt from the internal controls provisions of Sarbanes-Oxley and that the definition of an audit of internal controls be weakened for companies with market capitalization up to $700 million.[2]

[2] The Small Business Advisory Committee's recommendations, in addition to being substantively misguided, also assume mistakenly that the Securities and Exchange Commission has the power to exempt public companies from Section 404 or to waive the requirement that there be an outside audit of companies' internal controls assessment. Section 404 of the Sarbanes-Oxley Act explicitly requires all public companies to attest to the adequacy of their internal controls and to obtain an outside audit of their attestation. The Sarbanes-Oxley Act provides an explicit exemption for investment companies and no further exemptions. Consequently, neither the Commission nor the PCAOB have the authority to either exempt public companies from complying with these internal controls provisions or from obtaining a genuine audit of their attestation. This issue is discussed in the dissent to the Advisory Committee's final report by Kurt Schacht, the sole investor representative on the Committee, and is the subject of a letter from a group of leading securities law professors to the SEC and the PCAOB which is attached as an exhibit.

The Small Business Advisory Committee's recommendations would exempt a large percentage, perhaps as high as 80% of all public companies, from having to provide investors with transparency with respect to the effectiveness of their internal controls. Companies with a market cap of less than $128 million and revenue of no more than $125 million would be exempt completely from 404 requirements. Larger companies, with a market cap of up to $787 million and revenues of no more than $250 million, would not be required to undergo a genuine audit in which an independent, outside auditor tests their internal controls. According to the Advisory Committee itself, this would exempt companies with over $1 trillion in market capitalization from having to obtain an outside audit of the adequacy of their internal controls.

The AFL-CIO opposes any effort to exempt any public company from its clear obligations under the Sarbanes-Oxley Act. In addition, we strongly oppose any stealth effort to turn the audit of internal controls into anything other than what the statute requires—an audit sufficiently substantive to support an attestation by the audit firm that management's own assessment of its company's internal controls is correct. We believe it is irresponsible to allow companies without effective internal controls to sell securities to our members and the investing public. And we are not alone. There is virtual unanimity in both the institutional and individual investor community about the importance of protecting the current scope of Section 404—a consensus which includes the Council of Institutional Investors, the American Association of Retired Persons, the

Consumer Federation of America and the Ohio and Florida Retirement Systems. Each of their comment letters are attached. In addition, distinguished financial leaders like the former Chairman of the Federal Reserve Paul Volcker and former SEC Chairman Arthur Levitt have opposed weakening 404. Their letter is also attached.

Public companies by definition are companies whose compliance structures are sufficiently developed to allow these companies to sell their securities to the general public without placing the public in undue jeopardy of being defrauded or victimized by material error. That line of thinking is what produced the Securities Act of 1933 and the Securities Exchange Act of 1934, and it has motivated the federal securities regulation system since those Acts were adopted.

Not all companies are public. The United States has the most robust private capital market in the world, substantially made up of investors who specialize in evaluating private market opportunities. Private companies are entitled to assume their investors are highly sophisticated parties with an ability to independently assess the reliability of a private companies' financial statements through direct contact with management. Public companies, on the other hand, are allowed to market their securities to the public—to people with neither the time nor the expertise to be able to assess accuracy of company financial statements—to read them yes—to determine whether they are fraudulent or mistaken, no.

Since 1933, the federal government has required companies that wish to sell their securities to the public to bear a number of costs related to investor protection—including filing fees to the Securities and Exchange Commission, the costs of preparing prospectuses and periodic reports, including hiring lawyers, obtaining a clean report from an outside auditor and the like. Each of these costs is higher as a percentage of either assets or revenues or profits for smaller companies than for larger companies—and each has an effective minimum regardless of the size of the public company. Consequently charts that show that audit costs or 404 compliance costs as a percentage of revenues rise as companies size shrinks, and rise steeply at the microcap level could easily be reproduced for a variety of costs inherent at being a public company—from the legal fees to the copying or information technology costs.[3]

Why is an assessment and audit of internal financial controls necessary? Internal controls are the mechanisms that ensure that company financial statements are honest and accurate. They range from passwords on key spreadsheets to systems for counting inventory. If internal controls are weak, that weakness casts doubt on the accuracy of company financial statements. In the absence of internal controls, company financial statements simply cannot be relied upon. For that reason, the AFL-CIO believes that any

[3] For example, the Advisory Commission's report on page 31 shows a chart of audit fees as a percentage of revenue. For public companies with market capitalization of less than $25 million it climbed steeply from 2000 to 2004.. This is not at all surprising in light of the commitment on the part of the Congress, the SEC and PCAOB to restore integrity to the audit process by removing the subsidy and corrupting influence of non-audit related services. Assuming revenues of $12.5 million on average for these companies, many of whom are early stage ventures with very little revenue, the climb of approximately 1% in revenue represents an annual increase in audit costs over the four year period of approximately $125,000.

company seeking money from the investing public must have an outside audit of the adequacy of its internal controls. Otherwise our members, their benefit funds, and the public are being asked to take a risk they cannot manage—the risk that the financial statements of the company in which they might invest their money are wrong.

Weak internal controls are strongly correlated with problems in company financial statements. Since larger companies (accelerated filers) began to comply with Section 404 more than a year ago, according to the corporate governance firm Glass Lewis most public company financial restatements have been at companies that have also had weaknesses in their internal controls.

While small companies will bear a disproportionate set of costs in complying with 404, small public companies also disproportionately are involved in restatements and SEC enforcement actions. According to Glass Lewis in 2005 the smallest companies were more than twice as likely to have to restate their financials as large companies. Dana R. Hermanson, a professor of accounting at Kennesaw State University, has found that smaller public companies "have accounted for the vast majority of accounting fraud cases brought by the Securities and Exchange Commission."

Finally, there is the issue of cost-benefit analysis. For accelerated filers, there are two ways of thinking about the costs versus the benefits. The first way is to try and compare the costs of complying with Section 404 with the costs involved in the collapse of a large capitalization public company. The costs of 404 compliance across the entire

public company universe according to those who oppose 404 was $35 billion, which is approximately a third of a percent of the market capitalization of the companies involved and is less than half the losses suffered from just one of the major corporate collapses that gave rise to Sarbanes-Oxley. To my mind and in the minds of most investors even this high estimate (compare Audit Analytics study that shows total audit costs including 404 for all companies in the Russell 3000 as $2.7 billion) seems like a reasonable insurance payment.[4]

The second way to think about it is to compare the costs with the benefits that accrue at the individual company level from company management getting a tighter grip on their business and being able to manage more precisely. These are the benefits alluded to by Jeffrey Immelt of General Electric when he said "I think SOX 404 is helpful. It takes the control discipline we use in our factories and applies it to our financial statements."

Of course, investors do not have an interest in needlessly expensive internal control audits, and there is merit to the view some have expressed that public company

[4] Committee staff has cited a graduate student dissertation that estimates negative market reaction to Sarbanes-Oxley as costing investors over $1 trillion. This paper suffers from numerous methodological flaws, primarily the characterization of political events so as to make their coincidence with market moves fit the author's hypothesis (e.g. every political event that coincides with a market downturn is characterized as a pro-regulatory event regardless of the event's actual meaning) and is contradicted by other multiple other studies, e.g. Rezaee, Z. and P. Jain, 2003. The Sarbanes-Oxley act of 2002 and security market behavior and Li, H., M. Pincus, and S. Rego, 2004. Market reaction to events surrounding the Sarbanes-Oxley Act of 2002. Working paper, University of Iowa.

auditors have overcharged companies in the initial round of audits. However, the appropriate response is not the repeal of investor protections, but sensible changes in the guidelines and rules for both issuers and auditors. For starters, the SEC should consider providing substantially more guidance to issuers in preparing their attestation on internal controls. Secondly, as Arthur Levitt discusses in his attached op-ed piece, there are a number of areas where audit firms appear to have inappropriately duplicated internal control documentation. In all of these areas the SEC and the PCAOB should be working between now and 2007 to lessen the burden on all issuers, and in particular smaller issuers.

But ultimately, the AFL-CIO believes that those who want to weaken Sarbanes-Oxley must answer the question—why should a company that cannot attest to the adequacy of its internal financial controls be able to offer its securities to the investing public?

In conclusion, the AFL-CIO is prepared to assist this committee as you continue your work in this vital area of investor protection and capital markets integrity. We appreciate the opportunity to testify today. Thank you.